

"CHINA: ECONOMIC PERFORMANCE IN 1985"

A REPORT

PRESENTED TO THE

SUBCOMMITTEE ON ECONOMIC RESOURCES, COMPETITIVENESS,
AND SECURITY ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE

PRESS COPY
HOLD FOR RELEASE UNTIL
APR 26

BY THE

CENTRAL INTELLIGENCE AGENCY

MARCH 17, 1986

J842-14.

China: Economic Performance in 1985

Summary

In 1985, Beijing confronted numerous problems arising from the implementation of economic reforms. Poor weather and confusion surrounding new agricultural policies caused China's grain output to fall for the first time in five years. Industrial output, spurred by greater use of economic incentives and relaxed central controls, grew more rapidly than Beijing intended--worsening longstanding bottlenecks in the economy. Inflation, as measured by China's official price indices, tripled in 1985, while its balance of trade worsened sharply and its foreign exchange reserves declined.

Despite these problems, China's economy registered some significant gains in 1985. Energy output increased by over 8 percent, largely because of enhanced production incentives, increased state investment, and technology acquisitions. According to official statistics, despite inflation, workers experienced an improvement in their standard of living. Moreover, government revenues increased over 20 percent in 1985, and Beijing claimed success in narrowing its budget deficit.

At a national conference last September, the Chinese Communist Party formally made reform its primary economic goal for the five-year period beginning in 1986. Chinese leaders, however, recently announced that no major new reforms will be implemented this year. Beijing apparently intends to improve its control of the economy--using both indirect economic levers and administrative measures--before proceeding with key price reforms.

Agricultural Performance in 1985--Mixed Results

Since the economic reforms were launched in 1979, agriculture has been the centerpiece of Beijing's effort to improve economic efficiency by

China: Economic Performance in 1985

17 March 1986

A paper prepared by the Central Intelligence Agency for
submission to the Subcommittee on International
Trade, Finance, and Security Economics of the
Joint Economic Committee, Congress of the United States

Note:

This report will be released to the public following the joint appearance of the Director of the Office of Soviet Analysis, Directorate of Intelligence, CIA, and the Deputy Director, DIA, before the Subcommittee.

Figure 1

China: Grain Production



UNCLASSIFIED

introducing pragmatic, market-oriented policies into an ossified planning system. While agricultural reforms are still the single most important success of the reform program--agricultural output increased at an average annual rate of 11 percent from 1981 to 1984--growth rates fell in 1985. According to China's State Statistical Bureau, agricultural output--not counting the production of rural industries--increased only 3 percent last year.

After three consecutive years of record harvests, grain output fell 7 percent in 1985 (see Figure 1)--a result of reduced acreage, flood damage, and confusion over new reforms that eliminated grain quotas and replaced them with a market-oriented contract system. Rapidly developing rural industries also pulled peasants away from less lucrative grain production. Reform leaders maintain, however, that surpluses from previous years will more than make up for the shortfall.

Notwithstanding the lower harvest, China became a net grain exporter in 1985. According to Chinese trade data, China exported over 9 million metric tons of grain last year--almost triple the level in 1984. Chinese grain imports were approximately 5.4 million metric tons--with about 800 thousand metric tons coming from the United States (see Figure 2).

Efforts to diversify agricultural production were bolstered by officially sanctioned price hikes. Output of sugar cane, peanuts, and oilseeds each increased by more than 25 percent last year, according to Chinese statistics. Production of meat increased by 14 percent, and eggs by 23 percent. In a planned effort to reduce stockpiles, cotton production fell by more than a third.

Industrial Performance--Overly Rapid Growth

China's industrial output increased 18 percent last year, according to Chinese statistics. This continued a trend of double-digit growth in industrial production that began in 1983 and accelerated in the second half of 1984. During the first half of 1985, industrial output expanded at a 23-percent annual rate, but efforts to cool the economy reduced the growth rate to 10 percent by the end of the year (see Figures 3 and 4).

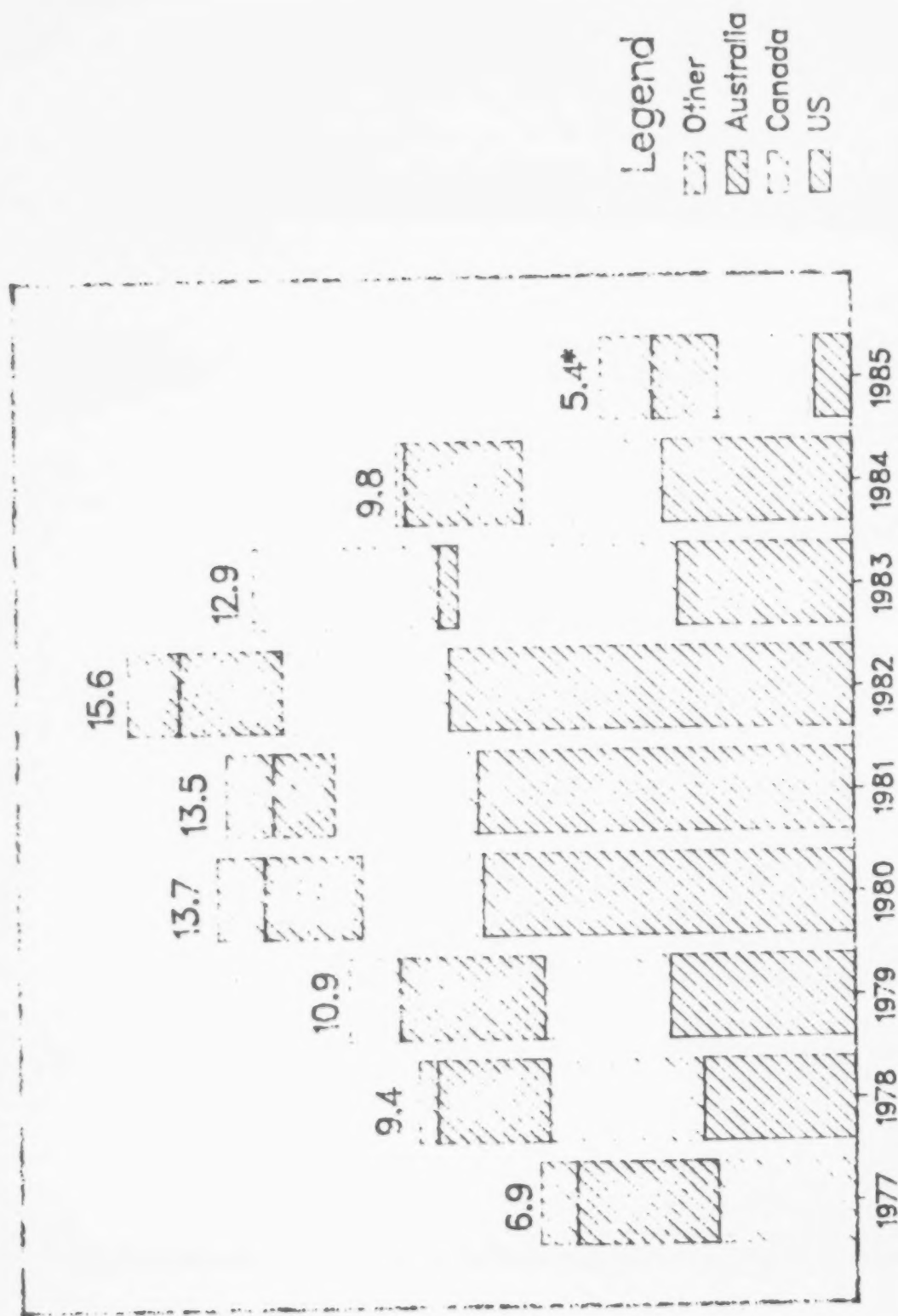
Rural industry was the most rapidly growing sector of China's economy in 1985. Chinese media reported that the output of rural factories shot up by 35 percent, and accounted for almost a third of total industrial production.

In light industry, buoyant consumer demand sustained a boom in the production of electrical home appliances. Output of washing machines, electric fans, and television sets increased over 50 percent, and production of refrigerators more than doubled. Output of building materials, heavy equipment, and machinery generally increased more than 15 percent during the year, while production of rolled steel increased about 9 percent.

Rapid industrial growth has been caused by skyrocketing investment spending--up by 35 percent in 1985--and a surge in wages and bonuses for industrial workers. Successful rural reforms have increased the availability of raw materials for industrial use, while boosting rural incomes and fueling consumer demand. Rapid industrial growth also has been facilitated by industrial reforms, particularly those allowing enterprises to sell overquota production at prices above the state-set levels. To a lesser extent, rapid growth last year was due to the technical modernization of some segments of Chinese industry.

Figure 2

China: Imports of Grain, by Source, 1977-1985



* Estimated.

UNCLASSIFIED

Major Indicators

The mixture of strong economic growth and relaxed economic control was evident in China's principal economic indicators.

GNP. Real GNP grew approximately 11-12 percent last year, about the same as in 1984.

Inflation. Although output grew rapidly in 1985, it was not sufficient to meet the strong demand for consumer goods, equipment, and building materials, and demand pressures boosted prices. According to China's official retail price index, prices increased 8.8 percent, triple the rate in 1984.

Energy Production. China registered 8-9 percent increases in coal, oil, and electrical production last year. China is the world's second largest coal producer, with output topping 850 million tons in 1985. Recent gains in production have been due to policies that eased restrictions on private and collective small-scale mining operations and that permitted state mines to sell overquota production at free market prices.

China produced about 2.5 million barrels of oil per day, exporting a quarter of the total. Gains in oil production were due to new finds and improved recovery technologies. Increases in electric power generation largely came from completion of new coal-fired facilities and increased deliveries of coal to power plants.

Foreign Trade. Loosened central oversight of foreign trade and a surge in investment and consumer spending led to a flood of imports--up 54 percent last year according to Chinese customs data. Because of strong domestic demand, Chinese exports increased by less than 5 percent--leaving Beijing with a 1985 trade deficit of \$14.9 billion. Because of the deficit, China's foreign exchange reserves fell 25 percent between September 1984 and September 1985. According to Chinese statistics, in 1985 China used \$2.4 billion in

Figure 3
China: Growth in Industrial Output

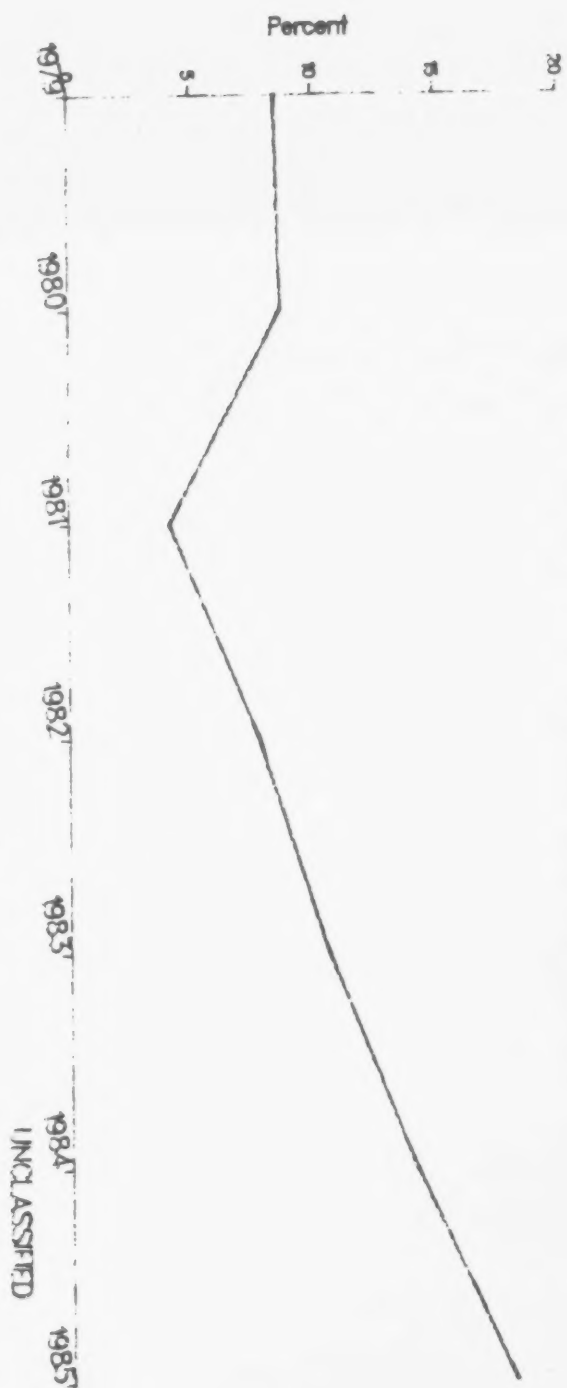


Figure 4
China: Growth in Industrial Output by Quarter
in Annualized Percentage Rate

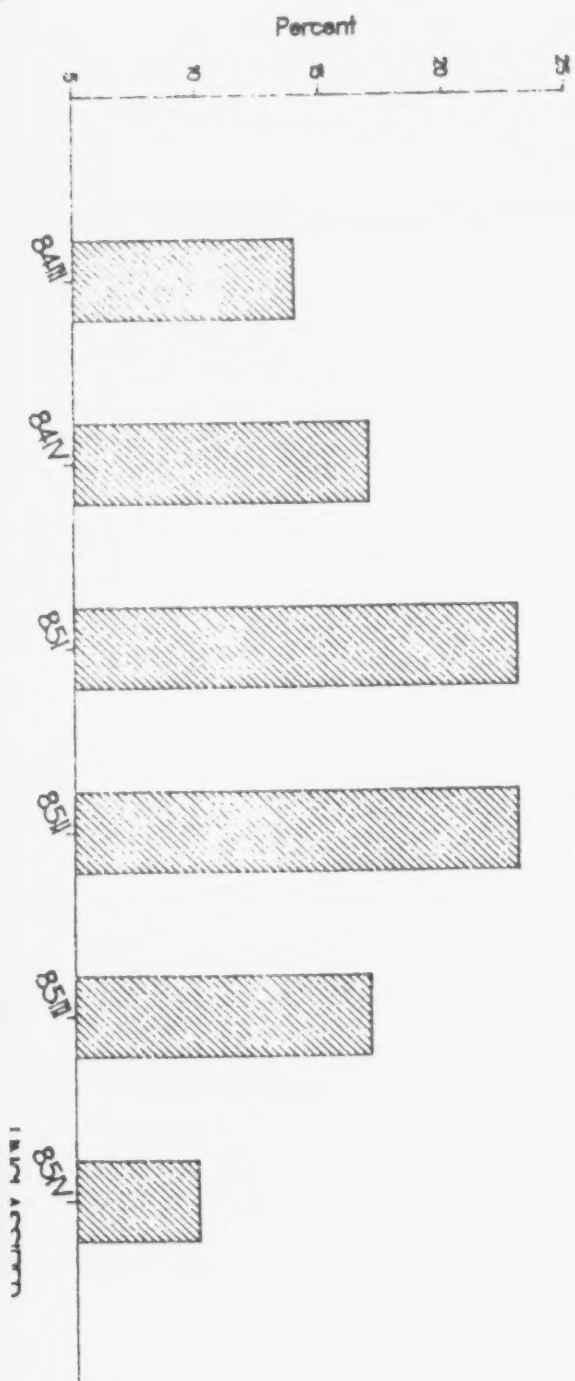
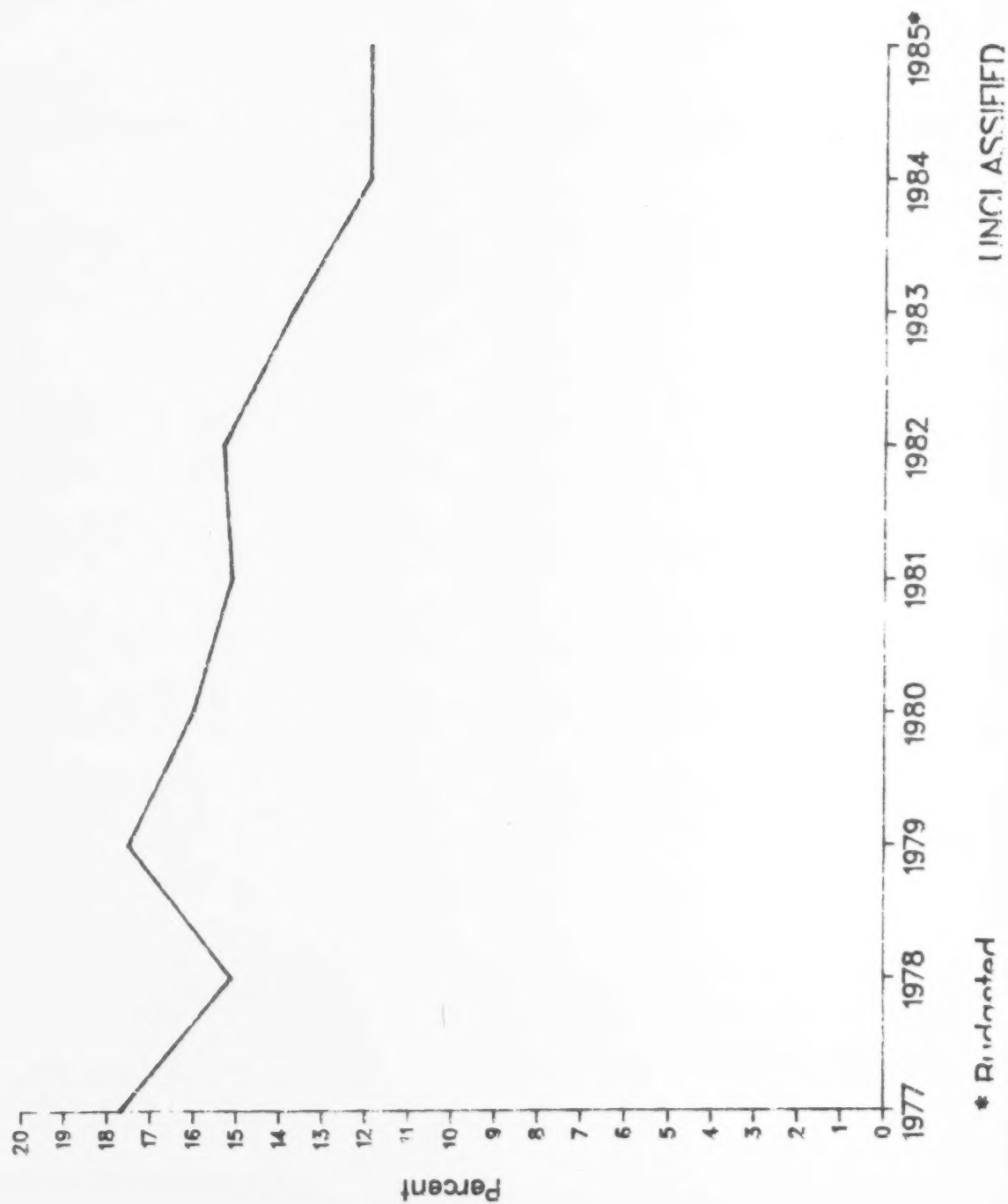


Figure 5

Announced Chinese Defense Expenditures as Percent of Central Budget



foreign loans and absorbed \$1.9 billion in direct foreign investment.

Government Budget. Strong industrial growth, rising prices, and increased tariffs on some imports pushed up government revenues by over 20 percent in 1985, despite media reports of widespread tax evasion. Although statistics on government spending have not yet been released, Chinese press reports indicate that Beijing believes the budget deficit was eliminated last year.

Defense Spending. Defense expenditures were budgeted to increase only 3.3 percent in nominal terms in 1985 to 18.67 billion yuan (\$5.83 billion at current exchange rates)--maintaining about a 12 percent proportion of total state expenditures. Spending for national defense is presented as a single line item in China's central budget, and there has been no official explanation as to its scope--the programs that the figures represent. Since 1979, defense spending has declined as a percent of total budget expenditures, reflecting the diminished priority given the defense sector under the economic reform program (see Figure 5).

Problems Associated with Rapid Growth

Beijing wrestled with a problem last year that, on the surface, is very unusual for a country at China's level of economic development--how to slow economic growth.

Despite the sharp increases in production of coal, oil, and electricity last year, energy supplies in China are strained. Additions to the transportation network have not kept pace with the growth in industrial output, and the system remains seriously overburdened. Chinese media report that factories still must suspend production occasionally because of shortages of electricity and delayed shipments of raw materials.

the rising cost of living apparently was a factor in student protests last fall.

Measures to Slow Growth

Beijing reacted quickly to data indicating the economy was overheating. After industrial output increased at a 23-percent annual rate during the first quarter of 1985, Beijing implemented a combination of market-oriented macroeconomic adjustments and administrative controls.

China's 1985 budget, announced in April, called for narrowing the budget deficit by slowing the growth of government spending. In particular, Beijing ordered a 10-percent cut in administrative expenditures. Beijing also began pursuing a tight money policy.

- In April, Beijing raised interest rates on time deposits and on loans for working funds. In August, it boosted rates on capital construction loans and again hiked time deposit rates.

- Lacking an established secondary market for government securities, China's banking system cannot conduct open market operations. Instead, Beijing reduces the money supply by increasing sales of goods from state-run stores. To soak up excess currency, Beijing set aside \$2 billion in foreign exchange reserves to be used to import scarce consumer durables, and the Ministry of Commerce was ordered to mark down prices of overstocked domestic commodities and increase sales to the public.

Many of the administrative controls were employed through China's banking system.

- China's central bank was ordered to set and enforce quarterly credit limits for its branches and the specialized banks (such as the Agricultural Bank and the Industrial and Commercial Bank).

- Banks were ordered to stop offering loans to inefficient enterprises and to firms that produce poor quality products for which there is little demand.
- Banks were prohibited from extending credit for capital construction projects whose spending exceeds the state quota or for projects not listed in the state plan.
- To prevent indiscriminate increases in wages and bonuses, enterprises were required to place wage funds in special accounts to be monitored by the banks.

Although industrial production has slowed since July 1985, recent statements by Chinese leaders suggest that Beijing remains very concerned with inflation, excessive investment spending, and its large trade deficit. Beijing probably will continue to tighten control over credit and capital construction this year.

Economic Reforms in 1985

The Third Plenum of the 12th Party Congress which met in October 1984 approved a general set of guidelines for expanding China's economic reform program to its urban areas. During the first half of 1985, Beijing announced initial steps toward price and wage reforms, while promoting increased autonomy for industrial enterprises. The first party document issued in 1985, however, signaled a new phase in China's agricultural reform program.

Second-Stage Agricultural Reforms

In 1985, Beijing implemented policies designed to broaden the influence of market forces on agriculture. Instead of setting mandatory purchase quotas for peasants to fulfill, the state now signs production contracts for grain (and cotton) with individual farmers. The contracted amounts generally are less than the previous quotas, and peasants are expected to sell surplus

production on the free market. The state has dropped its former commitment to purchase all overquota production at premium prices, and will now purchase excess grain only if the free market price falls below the set procurement price. In addition, the state no longer purchases nonstaple products such as vegetables, fruit, or meat--but state-owned marketing units in cities are being encouraged to sign contracts with peasants to improve supplies of nonstaples in urban areas. Finally, rural industry is being promoted to absorb some of the excess labor created by increasingly efficient agricultural production.

The new policies were designed to promote the development of a diversified agricultural sector and to encourage peasants to produce better quality products and make more efficient use of their land. The policies, however, probably elicited a stronger response than Beijing intended. Peasants were quick to switch to more profitable crops, such as oilseeds and vegetables. Strong consumer demand and readily available funds spurred the development of rural industries, and some peasants left their land idle to take jobs in industry. Much of the decrease in grain production in 1985 probably can be attributed to the new rural policies.

In recent months, reformers have bluntly defended the 1985 agricultural reforms against unnamed domestic critics--stating that the drop in grain output will not adversely affect the economy and highlighting the gains in production of cash crops and livestock and the important role that rural enterprises are playing. Nonetheless, agricultural policies for 1986 have been adjusted to boost grain production. Beijing has announced that it will increase state investment in agriculture and make available to peasants subsidized fertilizer and fuel. Generally, 1986 will be a year of "consolidation and digestion" of policies implemented last year.

Reforms of Enterprise Management

According to Chinese media, output has increased markedly in some factories in which managers have been given enhanced decisionmaking authority. The right to market overquota production seems to have been a particularly strong lever for increased efficiency and production. Chinese press reports, however, suggest that the implementation of increased enterprise autonomy has been uneven. Apparently, party officials and higher administrative units still make the important decisions in many factories. Other press reports indicate that many managers have taken advantage of their new authority by excessively increasing capital construction and randomly expanding wages and bonuses--two of the principal sources of economic instability in 1985. Chinese reformers are aware that the grant of autonomy is still onesided--managers have more flexibility in using enterprise revenues, but their decisionmaking is not yet disciplined by market forces. Beijing still subsidizes state enterprises that lose money, and experiments with enterprise bankruptcy laws have so far been limited, in part because the present system of irrational prices makes it difficult to determine which enterprises should be closed.

Price Reform

China's price system is irrational in that prices of many goods do not reflect relative market scarcities or the costs of production. State-set prices have been changed infrequently since the 1950s, and some goods are piled up in inventories while others are in chronic shortage. Within the next five years Beijing plans to establish a more rational, three-tiered price system. Prices of key products, such as coal and steel, will still be set by the state, but at levels that better reflect relative scarcities in the economy. Prices of many other products, including most manufactures, will

fluctuate in response to market conditions within bounds set by the state. Supply and demand alone will determine the prices of minor consumer goods--for instance, some clothing products, cosmetics, and vegetables--and over quota production of most industrial goods.

Beijing took a cautious approach to price reform in 1985. The key reform implemented was the removal of controls on retail prices of vegetables, meat, and other nonstaple farm products. Beijing also removed price controls on some consumer goods, and--to encourage greater use of highway transport--raised short-haul railroad rates for passengers and freight.

While Chinese media report that the reforms have prompted gains in efficiency, higher prices--particularly for food--have sparked widespread complaints. Because the planning system generally kept inflation low in the past, consumers and Chinese leaders are sensitive to price hikes. Reform leaders probably are concerned that if they relax price controls on additional products, the current excessive demands for consumer and investment goods would boost the inflation rate--so they have postponed major price reforms until after 1986. While maintaining price stability is the major goal this year, Beijing may implement some minor adjustments, such as widening price differentials for similar products of differing quality.

Wage Reforms

Chinese reformers, recognizing that Maoist egalitarianism corroded labor productivity, are encouraging enterprise managers to reward workers for superior skills and performance. Last year, some industrial enterprises, on a trial basis, were allowed to float their total wage funds upward or downward based on the amount of profits earned and the amount of taxes delivered to the state. In July 1985, Beijing announced a wage reform package for teachers and

government workers in which wages are to be based on the employee's position, seniority, and performance.

Wage reforms ran into serious snags last year. Unauthorized across-the-board wage hikes for factory workers contributed to inflation and undermined efforts to link remuneration to performance. Wage reforms for teachers and government workers fell almost a year behind the original timetable, delayed, probably, by budget concerns and reluctance to add to inflationary pressures.

Readjustment and Consolidation

Deng Xiaoping and other top Chinese leaders remain committed to reform, despite the economic dislocations in 1985. The economic problems, however, have forced Beijing to slow the pace of reforms.

In major speeches early this year, Chinese leaders called for a period of consolidation and adjustment in the reform program. Premier Zhao Ziyang stated recently that no major price reforms would be implemented in 1986, and in his speech to the national party conference in September 1985, he suggested that Beijing might need a two-year readjustment period to perfect macroeconomic control techniques. Chinese economic leaders probably realize that further price and wage reforms might be destabilizing in an inflationary economy, and that they must improve their ability to use indirect economic levers, such as taxes and interest rates, to regulate the economy. The two-year time frame mentioned by Premier Zhao probably is a guideline for the readjustment period. Beijing may move ahead with key reforms as soon as it is confident that capital construction is under control and that it has improved its economic regulatory mechanisms.